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Jennifer J. Johnson, Secretary
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regs.comments@federalreserve.gov

Robert E. Feldman, Executive Secretary
Attention: Comments
Federal Deposit Insurance Corporation
550 17th Street, NW
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Regulation Comments
Chief Counsel's Office
Office of Thrift Supervision
1700 G Street, NW.,
Washington, DC 20552
Attention: No. 2005–14
regs.comments@ots.treas.gov

Re: Interagency Proposal on the Classification of Commercial Credit Exposures: **FDIC** – no docket number; **FRB** - Docket No. OP–1227; **OCC** - Docket No. 05–08; **OTS** – Docket No. 2005–14; 70 Federal Register 15681; March 28, 2005

Dear Sir or Madam:

The Federal Deposit Insurance Corporation, the Board of Governors of the Federal Reserve Board, the Office of the Comptroller of the Currency, and the Office of Thrift Supervision (the Agencies) propose a new classification system for commercial credits. The proposal would affect all commercial banks and savings associations. The American Bankers Association (ABA), on behalf of the more than two million men and women who work in the nation's banks, brings together all categories of banking institutions to best represent the interests of this rapidly changing industry. Its membership--which includes community, regional and money center banks and holding companies, as well as savings associations, trust companies and savings banks--makes ABA the largest banking trade association in the country.

The current commercial credit classification system, which dates from 1938, has four basic categories: "special mention," "substandard," "doubtful," and "loss." According to the Agencies, rating differences between an institution and its supervisor commonly arise under the current classification system when, despite a borrower's well-defined credit weaknesses, risk mitigants such as collateral and the facility's structure reduce the institution's risk of incurring a loss. Transactions with significantly different levels of expected loss receive the same rating. To correct this, the Agencies propose a two-dimensional rating framework that considers a borrower's capacity to meet its debt obligations separately from the facility characteristics that influence loss severity.

The proposal is complex, and the Agencies ask a number of questions about the proposal. ABA asked a group of community bankers to review the proposal and answer those questions. We also received comment from several large banks that anticipate adopting the proposed Basel II Capital Accord. The responses to the questions we received from community bankers were surprisingly similar, and all of the bankers from whom we heard were in general consensus on the response to the proposal. We set out the consensus and answers to the specific questions below.

General Consensus on the Proposal

The general consensus of the bankers was that they did not support adopting the proposed new classification system. While overall it might provide somewhat more detailed analysis of the probable loss on commercial credit exposures than the current classification system, the current system simply is not so inadequate that it needs to be replaced with this proposal.

ABA emphasizes that this was not a hasty conclusion of the bankers. Each of the community bankers did a trial run through the bank's commercial portfolio. Most reported little change in classification, but said that might reflect the current economic period as well as their conservative underwriting. One banker reported a significant decrease in substandard that he believed was due to the fact that a local downturn in the economy causing more borrowers to be rated substandard under the current system while the facilities on his loans were strong and likely to have no loss (as the Agencies suggest the system should work). However, he felt that this was temporary and would reverse this year. Further, although the bank's substandard commercial credit assets was up, his internal classification system, which he would review with examiners, indicated that his portfolio was not troubled, and he believed that the examiners would agree.

Large Basel II banks said that the proposal appeared to differ in many respects with what they would be doing after final adoption of the Basel II Capital Accord, and they did not see the value of running two different classification systems and saw considerable difficulty in trying to resolve the differences.

Consistent across all of our bankers was the conclusion that the proposal was not a bad proposal, but that it was not a necessary proposal and the timing of the proposal was bad. All reported that they were currently engaged in implementing Sarbanes-Oxley auditing and control provisions, in ensuring that they met all of the BSA/anti-money laundering/OFAC and other anti-terrorism requirements, in analyzing and explaining their new HMDA data, implementing new home equity lending and overdraft protection guidelines, and in complying with other regulatory changes. Implementation of this proposal would therefore be more problematic for them at this time, and doubly so since they did not perceive any real need for this change.

Community Bankers' Responses to the Questions

1. The Agencies propose this as a framework for all sizes of institutions. What is the size of your institution and is your institution able to implement the framework?

Sizes of the institutions range from $110 million to $830 million, and within this size range the answers were very similar. First, every institution indicated that it could implement the proposal policy. Most indicated that they already use more detailed ratings systems internally, such as the 8 ratings system from Jack Henry. However, all of the currently used ratings systems "map" directly to the Agencies' current classification system, so that there is little wasted effort in using two ratings systems in the bank.

2. If not, please provide the reasons why it would be difficult or impossible to do so.

This question did not apply, since all of the institutions participating indicated that they could implement the proposed system.

3. The Agencies want to know what types of implementation expenses would financial institutions likely incur? Can you make an estimate of these expenses?

All of the institutions foresaw both system programming changes and training. The larger the institution, the higher the training costs, so that for several respondents the cost of training all of their commercial lenders actually outweighed estimated system programming costs. Part of the problem appeared to be that none of the more detailed loan evaluation systems now used by the banks easily mapped to the proposed classification system. All estimated costs of at least $50,000 but one estimated costs well above $250,000. However, all of the bankers responding stated that these were very rough estimates.

4. Which provisions of this proposal, if any, are likely to generate significant training and systems programming costs?

There were two major issues. First, all of the bankers were already using another, finer loan classification system for their internal controls, which all commercial lenders were responsible for using. The proposal would not map with these systems and so there would have to be either vendor changes to these systems or some internal programming or processing changes to produce results under the proposed system. None of the bankers believed that the proposal was significantly better than the internal loan grading systems they already were using. This mismatch would result both in programming and in training costs, as discussed above. The most training would be required for estimating the creditworthiness of the borrower and the risk of loss under the new system.

One banker noted that he would also have to provide additional education for his directors so that they would be able to understand how to evaluate the condition of the bank using the new system. He felt that his directors were already so busy meeting ever expanding regulatory demands on them that he really did not want to add anything more than was not completely necessary. Other bankers agreed with him.

5. Are the examples clear and the resultant ratings reasonable?

The examples were judged to be clear and the resultant ratings reasonable, if conservative. Two bankers thought more examples might be needed for understanding the treatment of asset-based lending under the proposal.

6. Would additional parts of the framework benefit from illustrative examples?

No specific suggestions were made.

7. Is the proposed treatment of guarantors reasonable?

Most of the bankers felt that the proposed treatment of guarantors was too conservative. In particular, it was felt that, under the proposal, most individual guarantors, no matter their net worth or position in the community, would not affect the estimation of the risk of loss. This did not seem to be consistent with the community bankers' experience with guarantors.

8. If the framework were adopted, how much lead time would your bank need to be able to implement it?

About two-thirds of the bankers estimated that it would take at least year. Two bankers thought that they could do it in six months and the rest thought that it might take up to eighteen months.

Conclusion

As we suggest above, it was the overwhelming consensus of both our community bankers and our large bank respondents that there appeared to be little benefit to making the change. Additionally, there appeared to be more cost than benefit; by a wide margin in some of the smaller banks. This, combined with all of the other regulatory and accounting changes that the bankers are already implementing, led them to conclude that they do not support adoption of the proposal. While there may be some banks (that are not anticipating adopting Basel II) that find the proposal more beneficial, none of the bankers with whom we discussed the proposal were in favor of it. As a result, ABA recommends that the Agencies do not adopt the proposal. If any of the Agencies have any questions about this comment letter, please call the undersigned.

Sincerely,

Paul Alan Smith

Paul A. Smith
Senior Counsel